(3)

No. 91-745



# In the Supreme Court of the United States

OCTOBER TERM, 1991

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JAMES AND NANCY L. KARR, PETITIONERS

*v.*

COMMISSIONER OF INTERNAL REVENUE

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*ON PETITION FOR A WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS
FOR THE ELEVENTH CIRCUIT*

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**BRIEF FOR THE UNITED STATES IN OPPOSITION**

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## QUESTION PRESENTED

Whether the activities of the limited partnership in which petitioner had invested were primarily motivated by tax benefits and lacked economic substance.

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## OPINIONS BELOW

The opinion of the court of appeals (Pet. App. A1-A38) is reported at 924 F.2d 1018. The opinion of the Tax Court (Pet. App. B1-B116) is reported under the caption *Smith* v. *Commissioner* at 91 T.C. 733.

## JURISDICTION

The judgment of the court of appeals (Pet. App. E) was entered on February 27, 1991. The petition for rehearing was denied by the court of appeals on May 7, 1991 (Pet. App. D). Justice Kennedy extended the time for filing a petition for writ of certiorari to and including October 2, 1991. The petition for writ of certiorari was filed on October 2, 1991. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

## STATEMENT

1. On their income tax returns for 1981 and 1982, petitioners claimed a distributive share of partnership losses of Peat Oil and Gas Associates, Ltd. (POGA) attributable to efforts to develop a process for producing alternative fuel known as the Koppelman Process. POGA and another limited partnership called Syn-Fuel Associates (SFA) were formed as part of a network of interrelated parties, allegedly to exploit Koppelman Process technology and to acquire and develop oil and gas interests. The offering memoranda reflect that each investor purchasing a partnership unit for a $37,500 cash investment would be able to deduct $150,376 in tax losses over four years. To be eligible to purchase units in the partnership, prospective investors were required to fill out an Offeree Suitability Questionnaire representing that they had a net worth of at least $250,000 (exclusive of home, furnishings and automobiles) and were subject to federal income tax in the highest brackets. The offering memoranda warned that financial success for the partnerships was highly unlikely due to the commercially unproven nature of the technology, the lack of experience of the principals, conflicts of interest on the part of many of the principals, the large obligations incurred by the partnerships without arm's length negotiations, and the inadequate capitalization of the partnerships. Pet. App. A4-A7.

As part of its activities in connection with the Koppelman Process, POGA agreed to pay a license fee to Sci-Teck Licensing Corporation (Sci-Teck) and a fee to Fuel-Teck Research and Development (FTRD). The fees to Sci-Teck and FTRD (both of which were part of the network of interrelated entities) were based on the number of partnership units sold (211.25 as of 1981) and included cash and partner-

ship promissory notes due between 2006 and 2009.[1] On its income tax return for 1981, POGA deducted \$4,288,375 as a license fee to be paid to Sci-Teck and \$4,288,375 as a research and development fee to be paid to FTRD. These amounts represented the cash payments and, to a larger degree, the face amount of the notes that were not due until 2006 or beyond. On its 1982 income tax return, POGA deducted \$5,830,500 as a license fee to be paid to Sci-Teck and \$1,964,625 as a research and development fee to be paid to FTRD, and also deducted \$505,897 as interest expense. Pet. App. A8-A11.

Petitioner James Karr became a limited partner of POGA in December 1981. The participation agreement called for payment of \$80,750 over a 26-year period, as embodied in full recourse promissory notes. On their joint income tax returns for 1981 and 1982, petitioners deducted \$20,191 and \$19,953, respectively, as their distributive share of partnership losses. The Commissioner disallowed these deductions, asserting, *inter alia,* that POGA had not entered into its activities for a profit. The Commissioner determined deficiencies in petitioners' income tax of \$8,907 for 1981 and of \$7,972 for 1982. Petitioners sought redetermination of their liabilities in the Tax Court. Pet. App. A10-A12.

2. Following a week-long trial, the Tax Court determined that tax motivations shaped the formation of these partnership transactions and concluded that

[1] The partnerships' oil and gas investments were to subsidize the efforts to develop the Koppelman Process. Fuel-Teck Oil and Gas, Inc. (FTOG) (another network entity) was to be responsible for those oil and gas activities. The revenue derived from oil and gas projects would be used to pay off POGA's notes to Sci-Teck and FTRD (Pet. App. A9-A10).

the partnership activities with respect to the Koppelman Process[2] lacked economic substance apart from the anticipated tax benefits. The Tax Court found that the substance of the transactions was that POGA provided cash to finance the promoters' activities for their various projects and, in return, POGA's limited partners were to receive tax benefits in the form of deductible losses. The Tax Court determined that such activities were not within the scope of Section 174 of the Internal Revenue Code, which permits a current deduction for research and development expenditures.[3] The Tax Court also sustained additions to tax under Section 6661(a) of the Code for substantial understatement of income tax for the 1982 tax year, and the imposition of additional interest under Section 6621(c) on substantial underpayments attributable to tax-motivated transactions for both 1981 and 1982. Pet. App. A13-A15, B82-B83, B90-B91, B103-B116.

3. The court of appeals affirmed. The court held that "the record contains substantial evidence from which one may conclude that POGA's Koppelman Process activity lacked economic substance and had no business purpose other than the creation of tax benefits" (Pet. App. A24). As a consequence, the expenses arising from those sham transactions are not deductible (*id.* at A30). The court of appeals also upheld the Tax Court's finding that POGA's

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[2] POGA had also claimed losses from oil and gas investments, the deductibility of which was conceded by the Commissioner following trial (Pet. App. A13).

[3] Section 174 authorizes a taxpayer to deduct currently, rather than treat as capital expenditures, "research or experimental expenditures which are paid or incurred by him during the taxable year in connection with his trade or business." 26 U.S.C. 174.

obligation to pay interest on promissory notes to Sci-Teck and FTRD was too contingent to meet the standards for accruing an interest deduction since the interest was payable only out of POGA's anticipated revenues and no payment was due for 25 years (*id.* at A31-A33). Finally, the court of appeals rejected petitioners' argument that the Commissioner had abused his discretion by imposing an additional interest charge under Section 6621 and a substantial understatement penalty under Section 6661 (*id.* at A37-A38).

**ARGUMENT**

The court of appeals correctly held that petitioners are not entitled to deduct their distributive share of the limited partnership's losses claimed in connection with the Koppelman Process because those activities lack economic substance. This decision does not conflict with any decision of this Court. The conflict of result between the decision in this case and the Sixth Circuit's reversal of the same Tax Court decision in *Smith* v. *Commissioner*, 937 F.2d 1089 (1991), is based solely on different factual conclusions drawn by the two courts and does not raise a legal issue warranting further review.

This Court has long held that transactions that lack economic substance will not be recognized for tax purposes. *Gregory* v. *Helvering*, 293 U.S. 465, 469 (1935). When a transaction represents "nothing more than a contrivance" in a scheme of tax avoidance, it will not be given effect. *Ibid.* The court of appeals correctly followed this principle in affirming the Tax Court decision that denied deductions for activities whose purpose and effect were tax avoidance.

In urging this Court to grant certiorari, petitioners contend (Pet. 13-14) that the court of appeals

should have reviewed *de novo* the Tax Court's determination that the partnership's Koppelman Process activities constituted a sham for tax purposes.[4] Although there is some variation among the courts concerning whether the determination that a transaction is a sham involves a question of fact or a conclusion of law,[5] there is no disagreement that the underlying factual findings upon which the characterization rests are subject to review only for clear error. Whether the ultimate label applied to POGA's activities was properly viewed by the court of appeals as a question of fact (with the legal standards applied by the Tax Court subject to plenary review) (see Pet. App. A19), or should have been viewed as a question of law (with the facts found by the Tax Court accepted unless clearly erroneous), see, *e.g.*, *James* v. *Commissioner*, 899 F.2d 905 (10th Cir. 1990), is largely a question of semantics. In either event, the characterization of those activities turns on the factual determination of whether the partnership had a profit motive and whether its activities had economic substance beyond the creation of tax benefits.

Petitioners acknowledge that in *Smith* v. *Commissioner*, 937 F.2d 1089 (1991), the Sixth Circuit ap-

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[4] The court below described the applicable standard of review as follows (Pet. App. A19) (citation omitted): "[T]he Tax Court's finding that a transaction is a sham is normally subject to the clearly erroneous standard of review; the legal standard applied by the Tax Court in determining if a transaction is a sham is subject to plenary review."

[5] Compare *Frank Lyon Co.* v. *United States*, 435 U.S. 561, 580, 581 n.16 (1978); *Knetsch* v. *United States*, 364 U.S. 361, 365 (1960); *James* v. *Commissioner*, 899 F.2d 905, 909 (10th Cir. 1990); *Killingsworth* v. *Commissioner*, 864 F.2d 1214, 1217 (5th Cir. 1989), with, *e.g.*, *Keane* v. *Commissioner*, 865 F.2d 1088, 1090 (9th Cir. 1989); *Comdisco, Inc.* v. *United States*, 756 F.2d 569, 575 (7th Cir. 1985).

plied "the same standard in determining whether the transactions had economic substance" (Pet. 15) that the Eleventh Circuit applied in the present case. In *Smith* v. *Commissioner*, a divided panel of the Sixth Circuit reversed as clearly erroneous the same Tax Court decision at issue here. While not addressing the factual analysis made by the Eleventh Circuit in its earlier published opinion in this case, the Sixth Circuit determined that the partnership arrangements were not devoid of any business rationale or economic reality and that the Tax Court's findings to the contrary were clearly erroneous.[6] Both the Sixth and Eleventh Circuits purported to apply the same standard of review to the Tax Court's determination. The courts differed only in their application of that standard to the particular facts in these cases. No significant legal issue is presented by this purely factual conflict. Further review is therefore not warranted.[7]

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[6] A strongly worded dissent by Senior District Judge Joiner, sitting by designation, concluded that the totality of the circumstances indicated that the Tax Court was clearly correct. *Smith* v. *Commissioner*, 937 F.2d at 1099-1104. Contrary to the Sixth Circuit majority, Judge Joiner concluded that "[t]hese partnerships were not business ventures, they were paper montages of likely Tax Court arguments" (*id.* at 1102).

[7] No legal issue of broad importance is raised by the petition's contentions concerning the proper weight given to the expert testimony petitioners presented in Tax Court (Pet. 16-17) and the relevance of certain testimony given by an attorney for the partnerships (Pet. 19), and there is no reason for this Court's review of either matter. Likewise, the court of appeals' decision that the contingent nature of POGA's interest obligation prevented its accrual as a tax deduction does not warrant this Court's attention, particularly where petitioners concede (Pet. 29) that events in fact oc-

## CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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curred that prevented payment of the interest. Finally, the court of appeals' conclusion that the Commissioner did not abuse his discretion under Section 6661(c) to waive the addition to tax assessed against petitioner for substantial understatement of tax in 1982 does not conflict with the very different issue resolved in *United States* v. *Boyle*, 469 U.S. 241 (1985), which involved the legal standards applicable to determining the existence of reasonable cause for failing to file a tax return.

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